Escorts Ltd

Company Profile

Escorts Limited (EL) is the flagship company of one of India's leading business groups, the Escorts Group. The company was incorporated in 1944 and is today, a leading manufacturer of Agri Machinery Products, Auto Suspension and Ancillary Products, Railway Equipment and Material Handling and Construction Equipment. The company is widely acknowledged as one of the pioneering agents of farm mechanization in the country and has been playing a pivotal role in the socio-economic progress of the country for more than five decades. Escorts is known to be an 'Indian multinational' and has established technological and business collaborations with leading companies across the globe. As far as figures go, the company has more than 1600 sales and service units, and footprints in over 40 countries. The management of Escorts takes great pride in their technological expertise which has seen the company introduce more than 45 different tractor variants within the 25 to 80 HP (Horsepower) range, over 16000 construction and material handling equipment and become the world's largest manufacturer of Pick-n-Carry cranes. The company's in-house R&D (Research and Development) unit is spread over 100,000 sq. and has been recognized by the Department of Scientific and Industrial Research, Ministry of Science & Technology, Government of India for the period of 2008-2011.

BUY ON DIPS **CMP: Rs. 191.17 (closing price as on 05/07/2010)** **Target: Rs 227 and Rs 243**

Business

The top line of the company arises from four main verticals, namely: - the agricultural machinery segment, the material handling and construction equipment segment, the railway equipment segment and the auto suspension and ancillary products segment. The company also derives a minor source of income from its stakes in various companies located in India and abroad.

Examining the historical performances of all these segments, it is quite clear that the agricultural machinery segment is the major driver of revenue. Historically that segment has contributed around 72% of the company's total sales (sales from FY07-FY09). This division of Escorts commenced operations in 1964 with the manufacturing of tractors being the key activity. Currently the manufacturing of tractors takes place in their Faridabad plant which churns out on average, around 260 tractors a day, in two shifts. However this facility has a manufacturing capacity of 400 tractors a day, with that level being reached only during peak periods. The Escorts' brand of tractors is immensely popular amongst the farming folk in the country, particularly in the northern territory. This statement is best exemplified by the fact that every third tractor in the country is an Escorts tractor. Principally Escorts offers three tractor brands namely: - Powertrac, Farmtrac and the eponymous Escort. The Powertrac brand is the utility and value-for-money tractors that functions on horsepower ranging from 34 to 55. The Farmtrac brand is the premium tractor that functions on horsepower ranging from 34 to 75 while the Escort tractor brand is the economy tractor that has twin-cylinder engines with horse power ranging from 27 to 35. Out of these three brands, the Farmtrac brand is the most popular, accounting for 50% of the company's total sales. The Powertrac brand is not far behind, accounting for 48% of total tractor sales while the Escort brand only accounts for 2%. In addition to India, the company exports tractors and other farm equipment to more than 40 countries.

Construction equipments serves as the second largest contributor of Escorts' sales, attributing for around 15% of the company's total turnover. As part of this segment, the company manufactures and markets a diverse range of construction and material handling equipment such as cranes, loaders, vibratory rollers and forklifts. The company has managed to garner quite a reputation through this segment as it is the world's largest manufacturer of Pick-n-Carrry cranes with that item generating more than 60% of the company's construction equipment sales. It also has a strong presence in the manufacturing of compactors which contributes another 25% of the total construction equipment sales.

The remaining part of the company's bottom line arises from the equipment division, which is further divided into the railway equipment division and the auto equipment division. Traditionally both these segments haven't contributed an awful lot to the company's total turnover (approximately around 8% over the last three years). Escorts is one of the oldest suppliers of high-tech equipment to the Indian railways, having commenced that relationship in 1970. The products of the railway equipment division are also exported to over 15 countries worldwide. As far as the auto equipment division is concerned the company has quite a strong presence in the country with an aftermarket of 300 dealers, 1000 retailers and 20000 workshops/garages. The company is considered to be a pioneer in the manufacture of automotive shock absorbers, having produced that product for two-wheelers and four-wheelers since 1966. Its auto division too is quite efficient with a manufacturing capacity of 5000000 units per annum. The company also follows a well-balanced market mix of its auto manufacturing parts, with 60% accounting for domestic sales while 40% accounts for exports.

The company's commitment to research and development is best exemplified through the "Escorts Institution of Farm Mechanization", a research institution located in Bangalore, and set up with the objective of enhancing the agricultural productivity and quality of life in rural India. Through this institution, the company is constantly striving to develop farmer friendly and fuel efficient products.

Segment

When Escorts first commenced operations, its general performance was closely tied to the agricultural sector. Today, while the performance of the agricultural sector continues to play a crucial role in the fortunes of the company, there are also other areas in which the firm is involved, such as the infrastructure and construction industry, the railways industry and the auto industry.

With 72% of the company's total sales closely linked to the agricultural sector, it wouldn't seem inappropriate to state that monsoons are pivotal to the company's business. A good monsoon will ensure an uptake in production and harvest and most certainly stimulate demand for the company's agri products (particularly the tractors). The Government of India too is very supportive of the agricultural industry and has allocated Rs.375000 crore in the union budget to this sector alone. Social factors too are contributing to increased farm mechanization. The migration of the rural class to urban areas with the prospect of better employment opportunities, particularly in the infrastructure and construction arena has lead to a massive void of labour in the farmlands. This has indirectly benefited Escorts, as farmers (including the small and medium ones) have been resorting to increased farm mechanization which includes the purchase of tractors. This trend is expected to continue with the uptake in construction activity in the urban areas resulting in more rural folk making the transition. Coupled with a good monsoon and increasing commercialization of the agriculture sector, demand is expected to pick up and stay at elevated levels in the foreseeable future.

Speaking of construction activity, the company is also actively involved in the manufacturing of construction and material handling equipment for construction firms. The construction equipment industry is an ever-growing and lucrative industry that is poised to reach USD 13 billion by 2015. Fiscal year 2011 is expected to be a mammoth year with projects worth Rs.6.5 lakh crore scheduled to be commissioned in India. That figure makes it the highest annual capacity addition in the Indian industry. The existing infrastructure deficit in the country, the buoyancy in capital expenditure and the influx of construction and infrastructure projects will enable the construction equipment division of Escorts to make a greater contribution to the bottom line. It is quite clear that Escorts is well poised to flourish, as agriculture followed by construction are the two largest economic activities in the country.

Escorts also derives revenue by providing hi-tech equipment to the railway industry and auto industry. Of the two, the service to the former is of greater prominence with Escorts having been involved with the Indian railways since 1970. The Indian Railways' revenue-earning freight traffic grew by 6.6% in 2009-10 and the growth in freight traffic is expected to remain steady at 6.3% in 2010-2011. Currently, the Indian Railways is in the midst of a major modernization and expansion programme and this is likely to trigger an uptake in the equipment manufactured by Escorts.

The automobile industry has been on a roll for a while now, with auto sales proving to be quite stellar on a year on year basis. Higher disposable income, moderate interest rates and the rising middle class are some of the key reasons for the uptake in auto sales. Calibrated hikes in the interest rates and the base effect will come into play in the months ahead and this could perhaps see sales growing at a much lesser rate. At things stand, the Indian auto component industry is highly fragmented where 77% of the value added comes from around 600 organized dealers and the remaining 23% of the value added comes from over 6300 unorganized players. Escorts with its brand name is well-positioned to garner a significant market share in this highly fragmented industry.

Outlook and Scope

Going by the numbers so far, the current fiscal (Escorts publishes its annual results every September) is already proving to be quite spectacular for Escorts and it would perhaps be fair to say that the best is yet to come. Volumes in the tractor industry have been growing at around 41% in the current year and historically, the period from April to September has been the best period for tractor sales, coinciding with the monsoons. A price increase of Rs.6000 per unit will also see the top line increase. To augment its already strong tractor sales, the company introduced two new tractors of high-horsepower range and intends to launch another 2-3 models during the next three months. The company is also looking to increase its capacity utilization. In the first six months of the current fiscal, the company produced around 28000 units and intends to add another 34000 in the remaining time period. Next year will see the company revamp the production capacity to around the 80000 levels with a target of 90000 being set for the year after next. At the moment, tractors with three-cylinder diesel engines have the biggest market share and it will not be long before four-cylinder diesel engine tractors, along with turbocharged engines and load-sensing technology and electronic-hydraulic hitch control become the norm. The company is constantly tapping into its strong R&D (Research and Development) culture in order to be well-geared to meet the demand for products of this sort. To facilitate all this, the company is also looking at new assets, news investments and a third location.

Just recently Escorts secured an order worth Rs.185 crore from the government of the United Republic of Tanzania. As per the order Escorts is required to submit 1430 units of its premium range of powerful Farmtrac tractors.

There also seems to be a renewed focus on its railway and construction equipment business. According to Rajan Nanda, the Chairman of Escorts, good progress is being made on expanding the rolling stock of vestibules, couplers, shock absorbers and other components of the metro and mono rail categories. The modernization of the railways has led to a greater demand for Escorts' railway products, where it has set a target of doubling its fiscal year 2009 railway segment revenue by 2012 (Revenue from the railway segment in Y09 was Rs.197.84 crore). Going forward they have plans to introduce 8 to 10 products over the next two years as planned in concurrence with the Indian Railways for their various programmes, including the development of a dedicated freight corridor, EMUs, high speed trains and so on. As far as the construction equipment division is concerned, the company is looking to enhance its earth moving equipment manufacturing capabilities and product portfolio. The construction equipment division saw the establishment of a state-of-the-art plant and the introduction of long tonnage cranes in the Pick-n-Carry category and compactors. Now the company is planning to introduce another 7-8 products over the next 18 months with the focus on earth moving equipment. Traditionally the construction and railway equipment divisions have grown at a CAGR of 35% and Escorts is expecting this high growth rate to continue.

All in all, the company is looking to pursue a multi-pronged strategy, with agri-machinery, infrastructure and the railways division as the core business verticals.

Financials

(In crores) Consolidated	SEP09*	SEP10E	SEP11E	SEP12E
Sales	2633.27	3468.76	4335.95	5463.30
PAT	28.6	123.60	152.36	204.01
EPS	3.03	13.10	16.15	21.6
P/E	63.26	14.63	11.86	8.87

** The company's annual financials are published every September*

Concerns

The most alarming figure staring out of the financial table of Escorts is the PE (Price Earnings) ratio in September 09. A company cannot continue to trade at such high levels as investors will soon lose faith in the stock. Fortunately enough, that predicament is set to change as there is going to be a more than justifiable surge in the EPS by September 2010 bringing down the EPS to levels that are prevalent in the industry. The company will also have to consider the performance of some of its subsidiaries which seem to be adversely affecting the consolidated profits of Escorts. Another cause for concern is the growing presence of Mahindra and Mahindra in the tractor segment.

Valuation

As previously mentioned in the 'concerns' section, the valuations of the company seem extremely stretched at the moment (with the PE ratio standing at a hefty 63.26). Clearly, for the company's stock to be trading at such a high price compared to its earnings, is unacceptable and there has to be some sense of justification. Hence scrutinizing the company's financials it is quite clear that much of the blame lies in the poor performance of some of the company's subsidiaries, as its standalone PE ratio stands at a much lower figure of 19.89. Historically while Escorts' standalone sales have stood at around 77% (three year average) of the consolidated sales, in most years, the profits generated by the company's core verticals have been eroded by the disappointing performances of its subsidiaries. For instance at the end of September 2009 while the company's standalone profits stood at Rs.89.73 crores, the consolidated profits stood at a much lower figure of Rs.28.6 crores. Going forward however, the consolidated PE ratio is expected to come down to a more acceptable figure of 14.63 (at the end of September 2010) mainly on account of a jump in the EPS in the current year (EPS is poised to increase by more than 4 times). If one is to carefully measure the performance of the company since fiscal year 2009, one will discover that the management has taken a lot of efforts to improve the performance of the company, most notably the operating efficiency. While sales had declined marginally from FY09 over FY08 the profits jumped by 2.8 times as the company saw a 10.3% increase in productivity, 12% reduction in power consumption and an improvement in the operating profits by 149%. The cost of raw materials which averaged 75% of the total sales until year 2008 saw a massive decline in year 2009 where it stood at only 63% of total sales. This has been carried forward to the half yearly performance of the current year as well. According to the management, the decrease in material cost was due to the continuous focus on cost reduction initiatives and innovative strategies to control cost and other expenses. Selling and distribution expenses too fell due to a better product mix and economies of scale. There was also a reduction in interest costs which was due to better working capital management, the introduction of a cash management system and a reduction in debt. As far as the company's half-yearly performance goes, its standalone sales have increased by 29% while profits have jumped by an astounding 767%. (6 month PAT at the end of March 2010 stood at Rs.64.87 crores compared to the 6 month PAT at the end of March 2009 which stood at Rs. 7.48 crore). It wouldn't be impudent to state that the company is only getting started as traditionally the time period from April to September is when the company really picks up steam with its agri-machinery division witnessing considerable attention due to the monsoons. While the company has already introduced two new tractor models in the current fiscal, it intends to introduce further 2-3 models by the end of the current fiscal and that, coupled with a Rs.6000 price hike should see the top line of the firm surge. The reduction in interest payments due to various measures (as mentioned previously) has already seen the consolidated debt-equity ratio decline to 0.69 from a high of 4.39 seen in 2003. The declension in interest payments coupled with better cost control initiatives and a stronger operating efficiency will see the company's net profits jump from Rs. 28.6 crore in Y09 to Rs. 123.06 crore (thereby increasing the EPS and consequently bringing down the PE. In the years ahead, the financial performance is likely to moderate with sales expected to grow at around 25-26% and profits expected to grow by 23-33% all the way until FY12. At a CMP of Rs.191.7 the stock is trading at 14.63 times its September10E earnings, 11.86 times its September11E earnings and 8.87 times its September12E earnings.

Investment Rationale

Until 2009, the financial performance of Escorts was quite subdued, in fact one could even go to the extent of saying that it was plain bad. The financials seemed to look quite chaotic as, when sales increased the company would post a loss and when the company actually ended up posting a profit, sales had surprisingly declined. Hence there was a lot of incoherence with regard to the company's performance. Post 2009 however, things seemed to have improved quite drastically. Despite a marginal decline in sales from 2008 to 2009 (Sales at the end of September 2009 was Rs.2689 crore compared to Rs.2633 crore at the end of September 2008) profits shot up by a whopping 164% and what's best is that it isn't just a one-time jump. It is quite evident that the management has implemented a whole host of initiatives (as previously mentioned in the valuations section) to ramp up the operating efficiency and reduce debt levels. Its debt equity ratio is at an extremely respectable figure of 0.69 and considering that the debt-equity ratio stood at an astounding 4.39 in 2003, it tells you how far the company has come. In fact when the company posts its yearly results for 2010 in September, it is likely to report a profit margin figure that is more than 4 times the profits generated at the end of September 2009. Sales too are expected to increase by 31%. This will see the annualized EPS jump by more than 4 times.The company's half yearly figures (posted at the end of the March quarter) have already proved to be quite stellar with standalone sales jumping by a monumental figure of 767%. Sales too have moved north by 30.2%. Thus after digesting all this, one may be tempted to ask, how exactly the company has made the transition from the bad to the good.

In 2009, the company redefined their profile from being an agricultural equipment, auto and rail component manufacturing company to a significant participant in the earth moving area. They then worked on their operating efficiency, implementing various cost reduction initiative and strategies to control cost and other expenses. They then improved their manufacturing efficiencies by eliminating defects and enhancing processes. They revamped their product mix (started focusing on the sales of high end tractors) leading to a reduction in selling and distribution expenses and economies of scale. Interest costs too tanked with the introduction of a cash management system and better working capital management. They also began to follow a sustained growth strategy with a strong focus on marketing activities. In addition to that they developed and implemented strong financial systems and controls, introduced engineered products, increased dealer penetration and placed more importance on the export market. So clearly the management needs to be commended for implementing all these measures which have most certainly translated into better financials for the firm. There seems little doubt that under the leadership of the current chairman Mr. Rajan Nanda the company will continue to flourish, particularly when one considers the lucid and effective corporate strategy that is in place.

Escorts already has quite a dominant position in the tractor industry where every third tractor is an Escorts tractor. They introduced two high end models in the current year and intend to introduce another 2-3 models before the end of the year. This coupled with a Rs.6000 price hike (the company has not ruled out further hikes) will see the top line improve significantly. Besides traditionally the period from April to September is one of great prosperity for the tractor business as it coincides with the monsoon period where farmers go in for greater mechanization. They have an exceptionally strong R&D culture (they have an institution located in Bangalore exclusively for Research on farm mechanization) and that coupled with their strong manufacturing efficiency (at its peak the Faridabad unit is capable of manufacturing close to 100,000 tractors p.a.) ensures that the company is well-placed to meet the surge in demand for hi-tech tractors. These two factors have given further support for the company to expand its presence and go in for an pan-India presence (it does not have a strong presence in south Indian) with the objective of increasing its market share. Just recently the company was able to secure a mammoth order to the tune of Rs.185 crores from the Tanzanian government. Under the deal Escorts is required to submit 1430 units of its premium tractor brand-Farmtrac. Incidentally this deal makes it the largest ever in the history of the Indian tractor industry and will go a long way in in strengthening the company's financials.

Escorts' relationship with the railways is a long-standing one and they are poised to reap the benefits of the government's decision to modernize the Indian railways. Escorts already enjoys the distinction of being the largest manufacturer of air brake systems in Asia. In addition to this title, it also enjoys various other benefits in the construction equipment industry being such a dominant player. It is the largest manufacturer of pick-n-carry cranes, the second largest in slew cranes and the third largest in the compactors segment. So it is quite clear that the company is well-placed to benefit from the pickup in infrastructure and construction spending.

When you consider that agriculture and infrastructure are the two largest economic activities in India and you have a company whose principal activities revolve around both those sectors, you know you're talking about a company that is really well-positioned. That perhaps is one of the biggest advantages of Escorts, in that it is not entirely dependent on any particular sector (even though the agri-machinery accounts for around 70% of the company's total sales). This diversified revenue profile that isn't tied to the agricultural sector, or infrastructure sector, or auto sector or railways sector has enabled the company to find some stability and balance in its finances, particularly its sales.

Considering all these factors it is fair to say that Escorts could well prove to be a real gem in the foreseeable future. **Investors with a 1-2 year time horizon are advised to consider investment in this stock with targets of Rs.227 and Rs.243**.

R E F E R E N C E

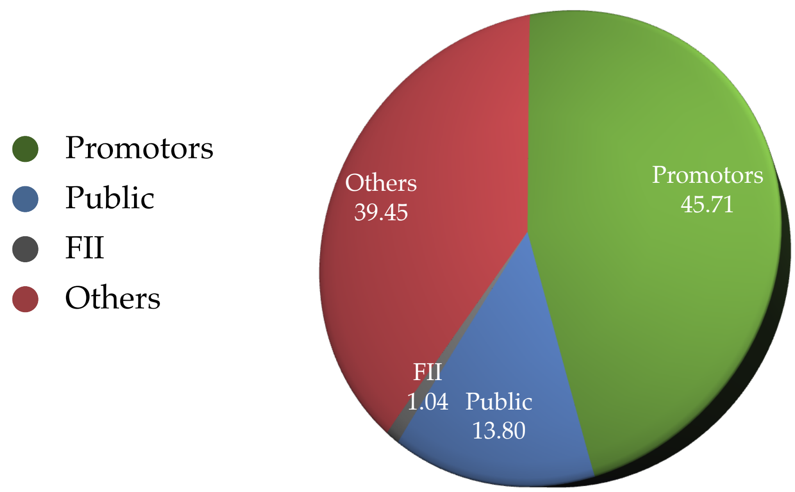
Major Investors

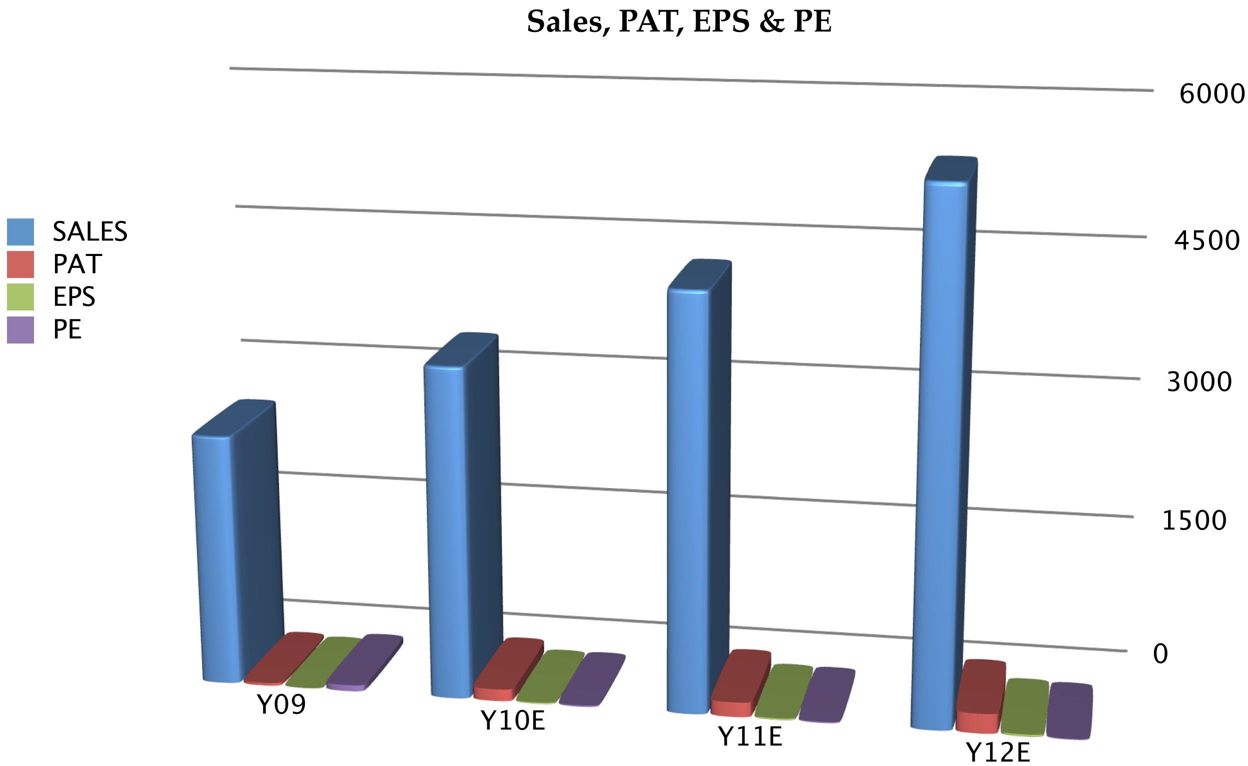
Tata AIG Life Insurance Company, SBI MF Magnam Midcap Fund, UTI Infrastructure Fund, HDFC Trustee Company Limited, SBI Mutual Fund, DSP Blackrock Mutual Fund

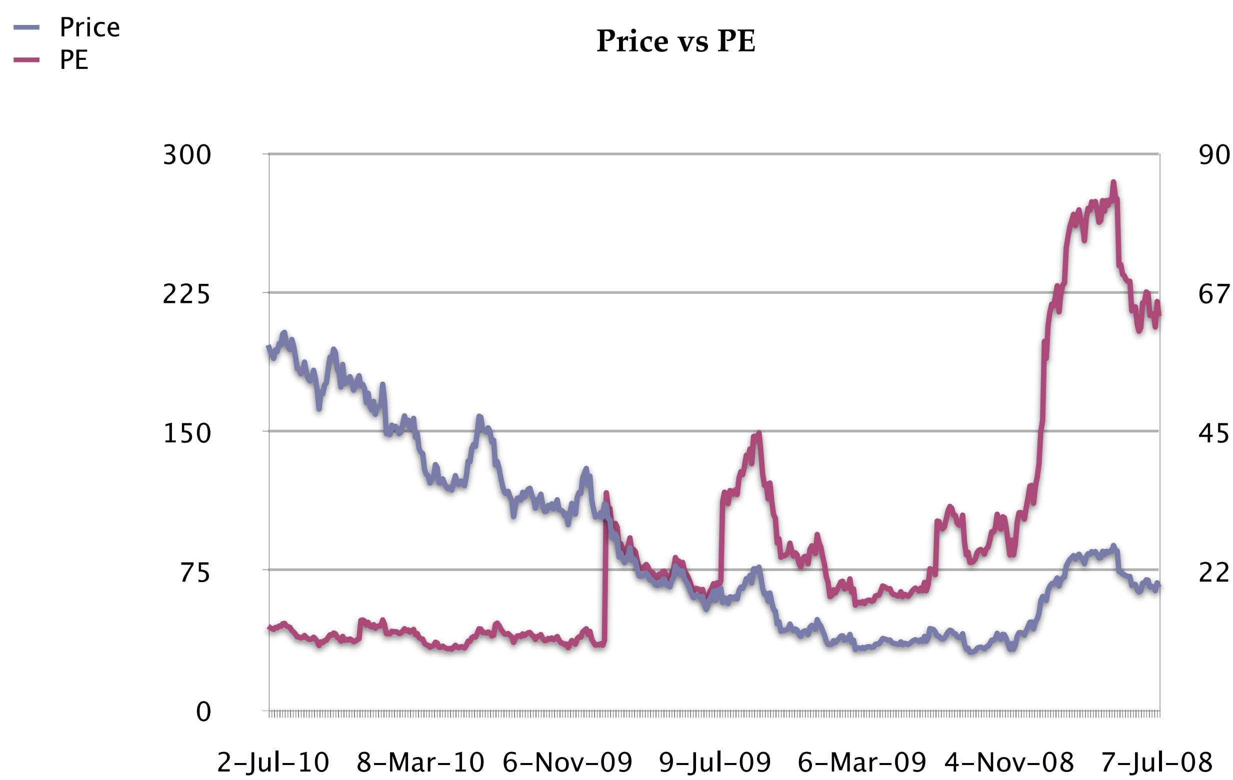
NAME OF THE SUBSIDIARY	ESCORTS LTD's STAKE
Escorts Construction Equipment Limited	100%
Farmtrac Tractors Europe Sp. Z.O.O	100%
Escorts Automotives Limited	100%
Beaver Creek Holdings Limited LLC	78.25%
Escotrac Finance Investment and Leasing Private Limited	49.81%
Escorts Securities	49%
Escorts Asset Management Limited	30%
Hughes Communications Limited	13.38%

Key Indicators			
EPS (TTM)	2.82	**Face Value**	Rs.10
P/E (with TTM – EPS)	69.74	**Equity Capital**	Rs.80.52 crore
Industry P/E	13.46	**Management**	Private Indian
Book Value	Rs.150.25	**NSE Code**	ESCORTS
P/B	1.37	**BSE Code**	500495
Beta	1.49	**ISIN Code**	INE042A01014
Debt -Equity	0.69		

Share Holding Pattern (Mar 2010)	
Promoters	45.71%
Public	13.8%
FIIs	1.04%
Others	39.45%
Total	100






Price
PE
Price vs PE
300
225
150
75
0
90.0
67.5
45.0
22.5
0
2-Jul-10
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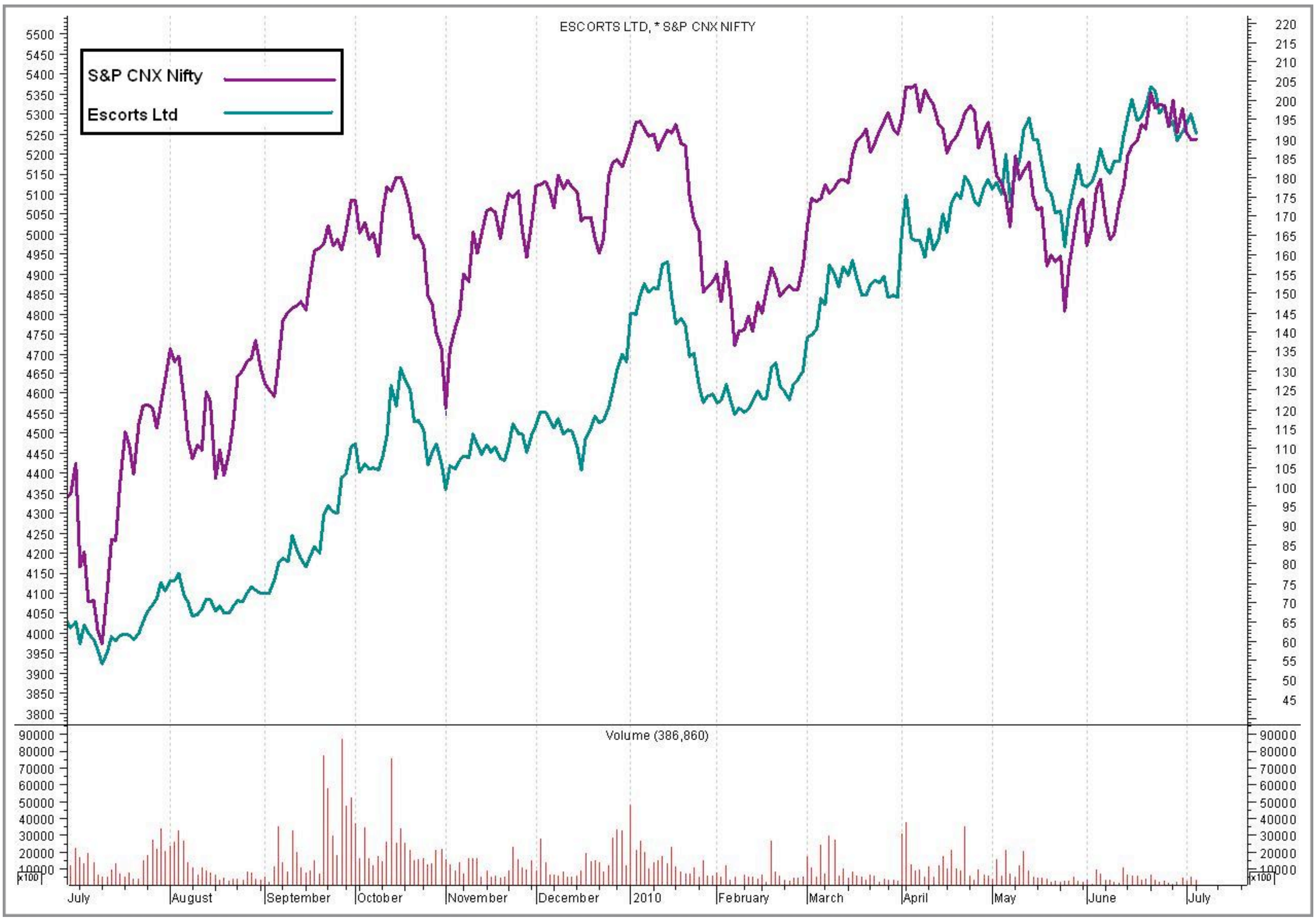
4-Nov-08
7-Jul-08


ESCORTS LTD, * S&P CNX NIFTY
S&P CNX Nifty
Escorts Ltd
Volume (386,860)
July
August
September
October
November
December
2010
February
March
April
May
June
July

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